BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
STANLEY A. AND LEONE M. ZIMMERMAN)

For Appellants: Stanley A. Zimmerman,
in pro. per.

For Respondent: Carl G. Knopke
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Stanley A. and Leone M. Zimmerman against a proposed assessment of additional personal income tax in the amount of $2,612.68 for the year 1973. Stanley Zimmerman and Leone Zimmerman are husband and wife. Leone Zimmerman is a party to this appeal only because the couple filed a joint income tax return. Consequently, Stanley Zimmerman will hereafter be referred to as "appellant."

The issues presented for decision are: (1) whether appellant is entitled to a deduction for intangible drilling costs: and (2) whether respondent correctly computed the tax on appellant's preference income..

Appellant is an airline pilot by profession, In December 1973, appellant entered into a series of transactions which purportedly were designed to give him a working or operating interest in an oil well under a "turnkey" contract.1/ The drilling program was conducted by three corporations, Surety Drilling, Inc., '74 Surety Management, Inc., and Amond Corporation. Thomas Jackson Stones, Jr., was the sole shareholder and chief executive officer of each corporation. All three corporations were headquartered in Encino, California.

Under the drilling program, Surety Drilling, Inc., was to lease property in Kern County. Each investor would execute a "turnkey" contract with Surety Drilling, Inc., for the drilling of an oil well at a particular location on these properties. The full contract price was normally $25,000, but a one-half interest could be purchased for $12,500. The contract price for a one-half interest was payable in a cash downpayment of $2,500. Thereafter, the investor would execute a document purporting to be a promissory note for $10,000 at eight percent annual interest to '74 Management Company. The note provided that neither the principal nor the interest was due until Surety Drilling, Inc., drilled a producing well. Thereafter, payments would be made only from production payments until the note was paid. The note was evidence of a $10,000 "loan" made to the investor by '74 Management Company to be used to pay the balance of the purchase price of the well. Ostensibly, this corporation loaned the investor $10,000, which was due for payment immediately. However, a second document which the investor was advised not to show to any taxing authority "to avoid the cancellation of your tax deduction," stipulated that the investor had no obligation under the note. The oil drilling venture was marketed by Amond Corporation and eventually sold to over 200 investors.

1/ A turnkey contract is a contract in which the drilling contractor, for a fixed price, furnishes all materials and labor required to complete a well, place it in production, and turn it over ready to "turn the key" and start oil or gas running into the tanks.

On December 26, 1973, appellant wrote a check for $2,500, which was paid to Surety Drilling, Inc. On December 31, 1973, he executed a promissory note for $10,000 to '74 Management Company for a total payment of $12,500. Two weeks later, on January 15, 1974, appellant received a letter from Surety Drilling, Inc., which described the general location of appellant's well. The letter stated that a.more' specific site location would follow shortly. In fact, only one permit was ever obtained to drill an oil well, and that well was never completed.

Thomas Stones, Surety Drilling, Inc., and Amond Corporation were subsequently indicted by the Grand Jury of Ventura County on 16 felony counts incorporating violations of the Penal Code, the Corporations Code, and the Revenue and Taxation Code. They were convicted of the fraudulent sale of securities and of conspiracy under Penal Code section 182, of violating, among other statutes, sections 19405 and 19406 of the Revenue and Taxation Code which relate to filing and causing the filing of fraudulent tax returns.

Appellant claimed a $12,500 deduction for intangible drilling expenses on his 1973 income tax return. Respondent determined that the intangible drilling costs were invalid and disallowed the entire deduction. Appellant protested, and, after reexamining the return, respondent allowed the deduction to the extent of the $2,500 cash down payment on the venture. Respondent now contends that its allowance of the out-of-pocket expense was erroneous, but it did not discover its error until after the statute of limitations had run on any additional assessments on the return.

Respondent argues that appellant is not entitled to a deduction for intangible drilling and development costs because appellant did not have a working interest in an oil well, and no expenditures were ever made for drilling a well.

Revenue and Taxation Code section 17283, subdivision (c), as it read in 1973, provided in pertinent part that:

> [R]egulations shall be prescribed by the Franchise Tax Board under this part corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the United States Congress in House Concurrent Resolution 50, 79th Congress.

Treasury regulation section 1.612-4(a) provides that "intangible drilling and development costs incurred by an operator ... in the development of oil and gas properties' may be charged at the election of the operator to capital or to expense. Federal courts have held that in order to be entitled to the deduction for intangible drilling and development costs, the person claiming the deduction must be an operator. This means that he must have a working interest in an oil or gas well, and the expenditures must have been for drilling that well. (Lloyd L. Cottingham, 63 T.C. 695, 706 (1975).) "To be an 'operator,' a taxpayer must establish, at the minimum, a link between specific contracts and himself with specific wells or drilling operations." (Ronald R. Levy, ¶ 82,419 P-H Memo. T.C. (1982).)

The facts in this case show that appellant had no working or operating interest in any oil well. No specific drilling site was ever assigned to him, and if one were, the record indicates that little, if any, drilling was done by Surety Drilling, Inc. For this reason, we sustain respondent's disallowance of appellant's claimed deduction for intangible drilling expenses. However, we also note that there is a question of whether the $10,000 appellant purportedly paid to Surety Drilling, Inc., on December 31, 1973, can be considered an actual payment for drilling and developing a well. Under an ancillary agreement, appellant was released from any liabili-ty to repay '74 Management the $10,000 which it "loaned" appellant to "pay" Surety Drilling. While the issue of a fraudulent tax deduction has not been raised in this appeal and is therefore not before us, we note that under such circumstances it can hardly be said that appellant actually paid the $10,000 for drilling and development costs.

We now turn to the issue of respondent's calculation of the tax on appellant's preference income. During the appeal year, appellant reported the following losses on his business/investment activities during the appeal year:

($29,134)	two farm losses
(39,777)	loss from a partnership investment
(12,500)	loss from alleged oil well investment caused by intangible drilling cost deduction
($81,411)	total losses from business/investment activities

Appellant considered these losses as deductions allowed by section 17252 of the Revenue and Taxation Code relating to expenses for production of income, He then considered these losses as his net business loss, pursuant to section 17064.6 of the Revenue and Taxation Code, and deducted the total amount in determining the amount of preference income subject to tax,

Respondent determined that appellant did not have any net business loss to deduct from his preference income and adjusted appellant's preference tax accordingly.

During the year under appeal, section 17062 of the Revenue and Taxation Code provided:

> In addition to the other taxes imposed by this part, there is hereby imposed for each taxable year, with respect to the income of every taxpayer under this part, a tax equal to 2.5 percent of the amount (if any) by which the sum of the items of tax preference in excess of thirty thousand dollars ($30,000) is greater than the amount of net business loss for the taxable year. (Emphasis added.)

The term "net business loss" is defined in section 17064.6 of the Revenue and Taxation Code as follows:

> For the purposes of this chapter, the term "net business loss" means adjusted gross income (as defined in Section 17072) less the deductions allowed by Section 17252 (relating to expenses for production of income), only if such net amount is a loss. (Emphasis added.)

The question of what are section 17252 deductions for the purpose of determining "net business loss" was addressed in the Appeal of Paul and Melba Abrams, decided by this board on January 11, 1978. We stated:

> We believe that by including the phrase "less the deductions allowed by Section 17252 (relating to expenses for production of income)" in the definition of "net business loss" the Legislature merely intended, for purposes of the preference income tax, to put taxpayers engaged in income producing activities not related to property held for the production of rents or royalties on an equal footing with those taxpayers engaged either in a trade or

> business or in income producing activities related to property held for the production of rents or royalties. This result is effectively achieved if the phrase under consideration is interpreted to mean only those section 17252 deductions (relating to expenses for production of income) not already reflected in adjusted gross income. Furthermore, such interpretation is the only one which is consistent with the legislative intent that the "net business loss" offset be directly related to the extent to which excess preference-income produces a tax benefit.

The adjusted gross income as reported by appellant was $87,848. The amount of section 17252 expenses permitted to adjust the adjusted gross income was $2,181. These were the job, tax, and investment expenses reported by appellant on his Schedule A and not reflected anywhere else on his return. Because these expenses were reported on his Schedule A,' they are below-the-line expenses and are not reflected in the reported adjusted income. The adjusted gross income less the section 17252 expenses results in a positive amount:

$87,848	adjusted gross income
- 2,181	section 17252 expenses
$85,627	

Because this amount is positive, by definition it is not a "net business loss" under section 17064.6. Consequently, appellant has no "net business loss" to decrease the amount of his preference income subject to tax under section 17062. This results in an amount of preference income subject to tax as follows:

$119,618	preference income reported by appellant
-30,000	statutory exclusion
$ 89,618	amount of preference income subject to tax

Appellant has asserted (1) that all of his business losses are section 17252 expenses, and (2) that these amounts are to be deducted directly from the preference income.

In the Appeal of Paul and Melba Abrams, supra, we specifically addressed the question of whether, for the-purposes of determining the amount of preference income subject to tax, section 17252 expenses include trade or business losses:

> Under appellant's view, the phrase "less the deductions allowed by Section 17252 (relating to expenses for production of income)" refers to all deductions related to the production or collection of income, including trade or business expenses as well as all section 17252 deductions. If this interpretation were accepted, a taxpayer engaged either in a trade or business or in an income producing activity related to the production of rents and royalties would be allowed, in computing the "net business loss" offset, a "double" deduction for the expenses incurred in connection with such activity. Specifically, the taxpayer would be allowed to deduct such expenses once in computing adjusted gross income and again in computing "the deductions allowed by Section 17252." However, if the "net business loss" offset reflected such "double" deductions, it would no longer be directly related to the extent to which excess preference income produces a tax benefit. Instead, certain taxpayers with substantial excess preference income would be able to completely escape the preference income tax even though the excess preference income significantly reduced their ordinary income tax liability. This is precisely the result which would be reached in the instant appeal if we were to accept appellants' construction of the phrase in question.

Additionally, per section 17064.6, the section 17252 expenses are to be deducted from the adjusted gross income and not from the amount of preference income reported.

We find that appellant's computation of the amount of preference income subject to tax is in error and that the amount determined by respondent is correct.

Appeal of Stanley A. and Leone M. Zimmerman

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Stanley A. and Leone M. Zimmerman against a proposed assessment of additional personal income tax in the amount of $2,612.68 for the year 1973, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day Of June, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Cha-irman

Ernest J. Dronenburg; Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

________________ Member